

African Development Bank Group



Domestic Resource Mobilization  
for Poverty Reduction in East Africa:

## **South Korea Case Study**

**Regional Department East A (OREA)**  
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## **Preface**

The African Development Bank (AfDB) has partnered with the African Tax Administration Forum (ATAF) and the East African Secretariat on a project aimed at sharing lessons of experience from Domestic Resource Mobilization (DRM) through case studies for the East African Community partner states (EAC), South Africa and South Korea. For the purposes of this work, DRM is defined to include only tax policy and administration and excludes other possible components of DRM such as domestic financial markets.

The overall objective of this project is to make recommendations, for the participating countries of the EAC, on the priority reforms and ways to sequence and implement them, in order to significantly enhance DRM. As such, the primary beneficiaries of the project are both the Ministries of Finance and the Revenue Administrations of the EAC.

This paper seeks to respond to the following question: What key factors have contributed to or inhibited DRM in South Korea? This case study has been prepared following an extensive review of available literature, interviews with individuals in South Korea, and the analysis of both primary and secondary data. Its development has also been informed by a methodological framework designed by the AfDB. The study adopts an explanatory case study approach to match patterns from our analysis of the literature and key informant interviews.

The achievements and lessons of experience contained in this and other country case studies will provide primary inputs for a policy note. The policy note will seek to address the following questions: What are the priority reforms for EAC partner states and the EAC? How should these reforms be sequenced and implemented?

## **Acknowledgements**

The South Korea Case Study was prepared under the overall supervision of Mrs. Diarietou Gaye (Regional Director, Department East A, OREA) and Catherine Baumont-Keita (Lead Economist, OREA). Core team members were Edward Sennoga (Macro Economist, UGFO and Task Manager, Richard Walker (Country Economist, KEFO) and Christian Lim (Private Sector Specialist, OSGE).

Mr. Aloysius Ordu (Vice President, Country and Regional Programs), Mr. Steve Kayizzi-Mugerwa (Director, Operational Resources and Policies), and Ms. Radhika Bharat (Investment Officer) initiated the project and were involved in the early design of the study.

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### **List of Abbreviations**

ATAF	African Tax Administrations Forum
BC	Before Christ
CTA	Certificated Tax Attorneys
EAC	East Africa Community
EDP	Economic Development Plan
EPB	Economic Planning Bureau
FDI	Foreign Direct Investment
FIPL	Foreign Investment Promotion Law
GCR	Gross Compliance Ratio
GDP	Gross Domestic Product
IMF	International Monetary Fund
KCS	Korea Customs Service
KDB	Korean Development Bank
KIPF	Korea Institute of Public Finance
KRW	Korean Won
MOSF	Ministry of Strategy and Finance
MoFPED	Ministry of Finance, Planning and Economic Development
NPF	National Pension Fund
NTA	National Tax Administration
NTS	National Tax Service
ODA	Official Development Aid
OECD	Organization for Economic Co-operation and Development
ONTA	Office of the National Tax Administration
PwC	Price Waterhouse and Coopers
SME	Small and Medium Enterprises
SSA	Sub-Saharan Africa
US	United States
USA	United States of America
URA	Uganda Revenue Authority
VAT	Value Added Tax
WTO	World Trade Organization
WDI	World Development Indicators

## Executive summary

**This case study explores some of the key achievements of Korea's tax reforms during its takeoff phase between the 1960s and 1970s, with a view to drawing useful lessons for East Africa Community (EAC) member countries today.** It is part of a broader Project on Domestic Resource Mobilization carried out by the African Development Bank. This project aims at sharing best practices among EAC member countries.

**Korea's development is one of the most successful and rapid in human history, yet during its takeoff phase, it was similar in many respects to EAC member countries today.** Korea's Gross Domestic Product (GDP) per capita grew from US\$ 130 in 1954 to about US\$ 19,115 in 2008. This growth was relatively well shared, as evidenced by a Gini coefficient of 32 in 2008 - equal to the European average. Korea implemented an export oriented infant industry strategy to transform itself from an underdeveloped country into a First World power in one generation. In the 60's, Korea's GDP per capita was similar to that of EAC member countries today and much lower than South Africa's. Korea was a fragile state, emerging from a devastating war with North Korea. It was also predominantly rural, with a large informal sector, much like the profile of some of the countries in East Africa. This formed the rationale for including Korea's tax experience during its takeoff phase in the Project.

**Tax reforms in the 60s and 70s consist in three phases which successively focused on: improving policies and laws, efficient implementation, and strengthening equity and introducing the Value Added Tax (VAT).** First, until 1966, reforms focused on increasing revenue collection and supporting growth, mainly through revising tax policies. This involved for instance merging a number of taxes, increasing the share of indirect taxes and using tax incentives to support selected sectors. Growth increased and reached 9.3% in 1963, which was later sustained. But revenue collection still fell short of expectations. The focus, therefore, shifted from reforming policies to implementing them efficiently. Consequently, the second period, from 1966 to 1974, focused on strengthening the tax administration. The creation of the National Tax Service as a semi-autonomous body in 1966 initiated a period of rapid revenue growth. During the third period, from 1974 to 1980, the importance of equity as an objective of tax policy increased and the VAT was introduced. Korea's tax reforms resulted in rapid revenue increase, from 9% of GDP in 1966 to 15% in 1980. Combined with a decrease in government expenditure, this enabled Korea to achieve fiscal balance, a priority strategic objective.

**Two lessons of particular relevance to EAC countries emerge from Korea's tax experience.**

**First, Korea achieved faster results by focusing its tax policies on a few priorities fully aligned with its national development strategy.** In the 60s and 70s, Korea's national strategy was on the one hand to rapidly achieve fiscal balance with a small government budget, and on the other hand to promote growth through an infant industry policy. However, trade-offs in the tax space were largely made up in other policy areas, for in particular through equity-oriented expenditure rural development programs and growth, which provided Korea with sustainable means to achieve equity. To this end, Korea successfully implemented tax policies focused on increasing revenues sufficiently to match low levels of expenditures by international standards, broadening the tax base, and providing incentives to strategic

sectors. In practice, less priority was given to other tax objectives, such as neutrality and equity. EAC countries are challenged by multiple tax objectives which can be conflicting if pursued at the same time. For instance exemptions can be necessary to provide safety nets or stimulate investments, but conflict with the objectives of broadening the tax base and minimizing distortions.

**Second, Korea broadened its tax base by making its tax administration both empowered and accountable.** The National Tax Service (NTS) benefitted from full support by top Government officials. NTS was shielded from political interference in its operations, as illustrated from the President's personal support to the Commissioner against external pressure. In addition, the enforcement capability of the tax administration was dramatically strengthened. For instance, three years after its creation, NTS staff headcount increased by 70% to reach 0.3 staff for 1000 inhabitants, 5 times the EAC average. On the other hand, the President was personally committed to the success of the tax administration, approving targets himself and closely monitoring performance. Operational empowerment and accountability for performance form a whole which together helped Korea succeed in broadening its tax base, as illustrated by a VAT Gross Compliance Ratio of 55% achieved by 1978, against 32% on average in the EAC today.

# 1 Introduction

- 1.1 **This case study explores some of the key achievements of Korea's tax reforms during its takeoff phase in the 1960s and 1970s, with a view to understanding what policy and administrative means Korea undertook, which contributed to its successful development and drawing useful lessons for EAC member countries today.**
- 1.2 This case study is part of a broader study on Domestic Resource Mobilization carried out by the African Development Bank. This Project aims at sharing best practices among East African Community member countries based on the experiences of South Africa and South Korea. As part of this Project, case studies or summary reports were prepared for each of the countries in the project (Burundi, Rwanda, Uganda, Kenya, Tanzania, South Africa, South Korea). The Project also included a study tour of Korea's tax system and history which took place in November 2009, which provided Korean and East African tax officials an opportunity to exchange views on their respective experiences. The objective of the comparative study is to draw lessons from the case studies, summary papers and study tour is to distill policy recommendations for East African countries. South Korea is included in the project in order to put East African experiences in perspective with that of a country, which faced most of the challenges presently faced by East African countries today, but which was able to use mobilize domestic resource to successfully further national development objectives.
- 1.3 South Korea's development is one of the most successful in human history, and yet it faced in the 1960s many of the challenges that many African countries still face today including, *inter alia*, (i) heavy reliance on foreign aid, (ii) an agrarian sector dominated by an informal economy, (iii) limited capacity of fiscal administration, and low tax base. In the 1960's, Korea's GDP per capita was similar to that of EAC member countries today and much lower than South Africa's. Korea was a fragile state, emerging from a devastating war with North Korea. It was also predominantly rural, with a large informal sector. Korea's GDP per capita grew from US\$ 130 in 1954 to about US\$ 19,115 in 2008. At the same time, Korea was able to ensure this economic growth was well shared, as evidenced by a Gini coefficient of 32 in 2008 - equal to the European average. Korea implemented an export oriented infant industry strategy to transform itself from an underdeveloped country into a First World power in one generation. In the



process, it also managed to undertake tax reforms that led to rapid tax revenue growth.

- 1.4 This case study also focuses on domestic and central taxes. Customs taxes are not covered in detail because the integration process of the EAC and international trade agreements will result in a reduction of the importance of customs taxes in the revenue composition of EAC countries. In addition, local taxes are not discussed because they remained at relatively low levels in Korea during the 1960s and 1970s, the focus period of this study, and very little research material seems<sup>1</sup> available on this. However, basic information on these taxes and on their contribution to total revenues is provided as part of the background for domestic and central taxes.
- 1.5 The case study is structured around three parts. Chapter two provides the “Background and context” presenting Korea’s development since the end of the Korean War in 1953, and discusses the comparability of Korea during its takeoff and the EAC today. Chapter three focuses on Korea’s tax reforms over time with a discussion on each phase of the country’s tax policies and administrative reforms. Chapter four discusses the key lessons that can be learned from South Korea’s experience which could be of guidance to EAC countries.

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<sup>1</sup> It is important to emphasize that Korea’s tax experience in the 1960’s and 1970’s is in general poorly documented. Most of the data used in this case study was actually produced by the National Tax Service, created in 1966. It took many years for NTS to produce comprehensive and consistent data sets. Much of the data used in this study is the result of a reconciliation and cross-checking of various sources. Some discrepancies could not be fully resolved. There was therefore also extensive use of qualitative information collected from the literature - mostly Korean - to check and complement the quantitative evidence available. Some uncertainty will therefore remain on the details presented in this paper. Nevertheless, the main findings of this study do emerge quite clearly from the evidence available.

## 2 Background

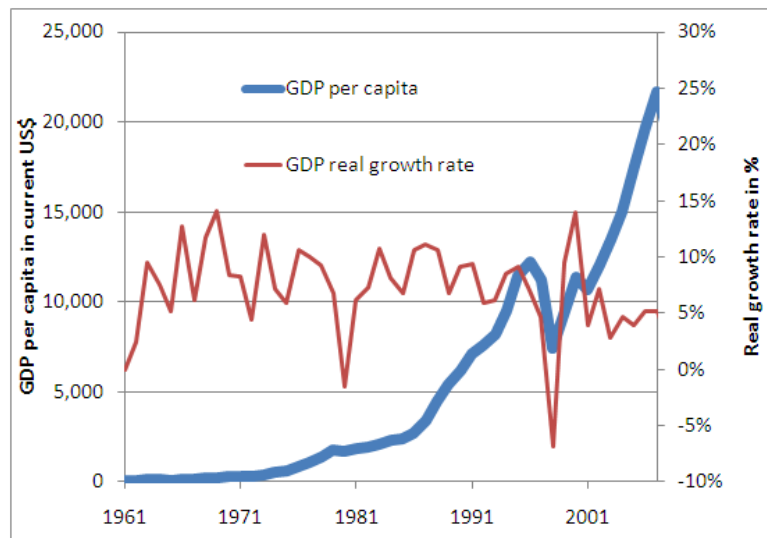
### 2.1 Korea's development experience and strategy

2.1.1. This section presents Korea's development since the end of the Korean War in 1953 until today, and provides a comparison of Korea during its takeoff with EAC today. Though the focus of this study is the takeoff period, this section provides an overview of Korea's development until today. Indeed, this is necessary to understand the long term consequences of the tax reforms during the takeoff period.

2.1.2. From 1962 to 2008, Korea's real GDP grew at an impressive rate of 7.2% on average, while achieving remarkable equity and social development. Korea's GDP per capita grew from US\$ 130 in 1954 to about US\$ 19,115 in 2008 (

2.1.3.

2.1.4. Figure 1: 50 years of growth in Korea



Source: WDI

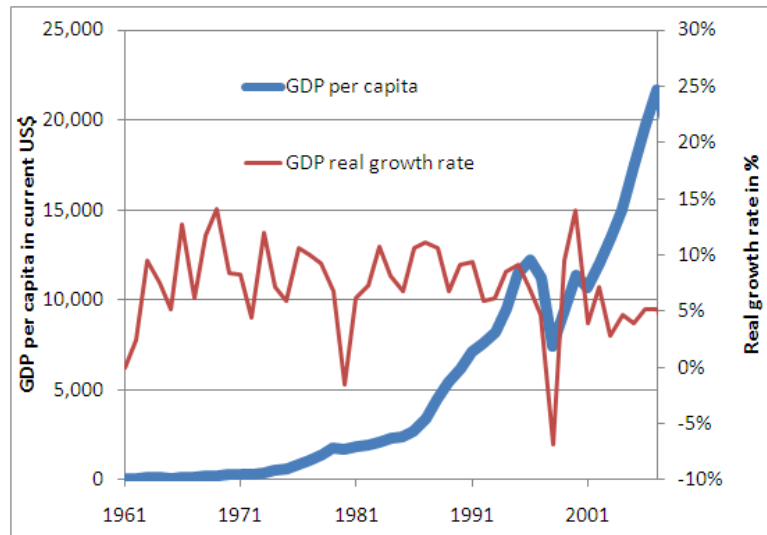
- 2.1.5. Following the Korean War, the military Government adopted an import substitution policy which did not result in significant growth. The import substitution policy was to a large extent devised to address the fiscal and current account deficits, which as a result, were widening.. The United States was the main provider of aid to Korea. Aid, until 1958, accounted for up to 45% of Government revenues and financed 70% of imports. In 1957, the US unexpectedly announced that it was phasing out its development assistance, which effectively started to decline from 1958.
- 2.1.6. In 1961, a military coup brought Park Chung Hee to power. He changed the country's national development policy from import substitution to export promotion based on the aspiration for national autonomy. His slogan was "From Poverty to Self-sufficiency". In order to design and implement this policy, President Park created a number of institutions, including the Economic Planning Board, established in July 1961 with the mission to develop 5-year Economic Development Plans (EDP), including both macroeconomic planning and detailed implementation plans. In addition, the Korea Trade Investment Promotion Agency was created which, among its responsibilities, included reporting progress on export targets directly to the President on a monthly basis.
- 2.1.7. The export strategy resulted in rapid growth in the 1960's and 1970's. It relied on intensive government intervention to protect and promote private investment in infant industries in selected sectors. Indeed, the Government considered that Korean industries had not reached the critical mass to be able to compete on international markets and therefore required protection as economies of scale were being built. Government intervention took many forms, in which tax incentives played a role. However, the central focus of government intervention was in financial markets. The support system included placing the Central Bank under the authority of the Government, nationalizing banks, proscribing lending objectives to the banks by sector, controlling interest rates, subsidizing credit and providing government guarantees. Other measures included: foreign exchange control - in particular the 1964 devaluation, pooled marketing boards - which in particular purchased imported inputs in bulk for Korean Small and Medium Enterprises (SME), selection of high potential SMEs for special support and close government performance monitoring, capacity building for SMEs, and overhauling the education system to supply skilled labor to the priority industries.
- 2.1.8. The first two EDPs, covering the 1962-1971 period focused on manufacturing exports, such as steel, machinery, and chemical industries. Basic inputs for production were also emphasized, such as coal, electricity, fertilizers, oil refining, synthetic fibers, and cement. The third and fourth EDPs focused on

- higher value added and heavy industry exports, including household electronics, cars, shipbuilding, and petrochemicals.
- 2.1.9. By the end of the 70s however, the distortions cumulated over 20 years of strong government interventions in the financial and labor markets had become unsustainable. In particular, some industries were suffering overinvestment and excess capacity. The wage of skilled labor increased very rapidly, up to 31% per year from 1974 to 1980. This along with the creation of rents in priority sectors, caused growing inequalities. This was aggravated by a persistent high inflation, which started with the first oil shock in 1973. Political opposition rised and culminated in the assassination of President Park in October 1979. After a brief political interregnum, General Chun Doo Hwan came to power through a coup.
- 2.1.10. In 1980, the change of regime, combined with the economic crisis, led to a shift from high government intervention to a liberalization policy. As General Chun took power the second oil crisis hit Korea, making a tight stabilization policy even more urgent. It was based on zero-based budgeting, including a freeze of public wages and a monetary squeeze. As a result, inflation declined from 21% to 2% during 1981-1984. In addition, the financial sector was rapidly liberalized, with four of the five largest banks being privatized, two commercial banks being created, along with many other private financial institutions, and government credit control progressively phased out. The Banking Act was amended to prevent Chaebols from owning excessive shares in financial institutions.
- 2.1.11. By 1986, Korea had resumed high rates of growth. It was in particular benefiting from a low dollar and low oil prices. Its current account surpluses reached 8%. Liberalization continued, with direct investment by foreigners in the Korean stock market being allowed from 1992 and Korea joining the World Trade Organization (WTO) in 1994 and the Organization for Economic Co-operation and Development (OECD) in 1996. The liberalization was considered successful until the financial crisis Korea in 1997 and international financial flows abruptly reverted. Identifying the root causes of the crisis is difficult as both pro and anti liberal interpretations of the Asian financial crisis can be found. However, there is a broader agreement that over-investment by the Chaebols and excessive maturity mismatches in financial institutions were some of the key reasons for the rapid loss of investor confidence. Korea's economy grew a little above 4% as a result of the crisis, which was very low compared to Korea's 8% average growth from 1962 to 1997. It has since recovered and grown at an average of 6.2% from 1999 to 2007. The 2008 financial crisis took a heavy toll on Korea, causing growth the decline to 2.2%

that year. Korea has since benefited from a steady recovery, in line with the faster growth of the global economy.

- 2.1.12. ). Korea's Gini index was 32 in 2008 - equal to the European average – reflecting the success of the model in mitigating the risk of high inequality despite rapid growth. Social indicators are also positive. For instance, life expectancy increased from 55 to 79 years from 1962 to 2008. Secondary school enrollment increased from 42% in 1971 to 98% today.

**Figure 1: 50 years of growth in Korea**



Source: WDI

- 2.1.13. Following the Korean War, the military Government adopted an import substitution policy which did not result in significant growth. The import substitution policy was to a large extent devised to address the fiscal and current account deficits, which as a result, were widening.. The United States was the main provider of aid to Korea. Aid, until 1958, accounted for up to 45% of Government revenues and financed 70% of imports. In 1957, the US unexpectedly announced that it was phasing out its development assistance, which effectively started to decline from 1958.
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- 2.1.15. The export strategy resulted in rapid growth in the 1960's and 1970's. It relied on intensive government intervention to protect and promote private investment in infant industries in selected sectors. Indeed, the Government considered that Korean industries had not reached the critical mass to be able to compete on international markets and therefore required protection as economies of scale were being built. Government intervention took many forms, in which tax incentives played a role. However, the central focus of government intervention was in financial markets. The support system included placing the Central Bank under the authority of the Government, nationalizing banks, proscribing lending objectives to the banks by sector, controlling interest rates, subsidizing credit and providing government guarantees. Other measures included: foreign exchange control - in particular the 1964 devaluation, pooled marketing boards - which in particular purchased imported inputs in bulk for Korean Small and Medium Enterprises (SME), selection of high potential SMEs for special support and close government performance monitoring, capacity building for SMEs, and overhauling the education system to supply skilled labor to the priority industries.
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- 2.1.17. By the end of the 70s however, the distortions cumulated over 20 years of strong government interventions in the financial and labor markets had become unsustainable. In particular, some industries were suffering overinvestment and excess capacity. The wage of skilled labor increased very rapidly, up to 31% per year from 1974 to 1980. This along with the creation of rents in priority sectors, caused growing inequalities. This was aggravated by a persistent high inflation, which started with the first oil shock in 1973. Political opposition rised and culminated in the assassination of President Park in October 1979. After a brief political interregnum, General Chun Doo Hwan came to power through a coup.

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<sup>2</sup> Interestingly, ambassadors were also given sales objectives and were assessed on this basis.

- 2.1.18. In 1980, the change of regime, combined with the economic crisis, led to a shift from high government intervention to a liberalization policy. As General Chun took power the second oil crisis hit Korea, making a tight stabilization policy even more urgent. It was based on zero-based budgeting, including a freeze of public wages and a monetary squeeze. As a result, inflation declined from 21% to 2% during 1981-1984. In addition, the financial sector was rapidly liberalized, with four of the five largest banks being privatized, two commercial banks being created, along with many other private financial institutions, and government credit control progressively phased out. The Banking Act was amended to prevent Chaebols<sup>3</sup> from owning excessive shares in financial institutions.
- 2.1.19. By 1986, Korea had resumed high rates of growth. It was in particular benefiting from a low dollar and low oil prices. Its current account surpluses reached 8%. Liberalization continued, with direct investment by foreigners in the Korean stock market being allowed from 1992 and Korea joining the World Trade Organization (WTO) in 1994 and the Organization for Economic Co-operation and Development (OECD) in 1996. The liberalization was considered successful until the financial crisis Korea in 1997 and international financial flows abruptly reverted. Identifying the root causes of the crisis is difficult as both pro and anti liberal interpretations of the Asian financial crisis can be found. However, there is a broader agreement that over-investment by the Chaebols and excessive maturity mismatches in financial institutions were some of the key reasons for the rapid loss of investor confidence. Korea's economy grew a little above 4% as a result of the crisis, which was very low compared to Korea's 8% average growth from 1962 to 1997. It has since recovered and grown at an average of 6.2% from 1999 to 2007. The 2008 financial crisis took a heavy toll on Korea, causing growth the decline to 2.2% that year. Korea has since benefited from a steady recovery, in line with the faster growth of the global economy.

## **2.2 Comparing Korea in the 60s/70s and the EAC today<sup>4</sup>**

- 2.2.1 In addition, this study focuses on Korea in the 60s/70s because it was then similar to EAC member countries in many respects. Korea was a post-conflict country emerging from the Korean War and was threatened of invasion from the North. Similarly, Burundi, Rwanda and Uganda have suffered from armed conflicts which have been followed by continued tensions.

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<sup>3</sup> Chaebols are large family-owned Korean business conglomerates which benefitted from strong government support to become powerful multinationals. There are several dozen Chaebols, including well known brands such as Samsung, Hyundai and LG.

<sup>4</sup> For discussions on the specificities of Korea's initial conditions and their implication on the replicability of its approach to development have discussed extensively. Examples can be found in the "Korea's Development experience" section of the list of references in annexes.

- 2.2.2 Korea in the 1960s was in the same income group as the EAC today. After adjusting for inflation and purchasing power parity (constant 2005 US\$ at PPP)<sup>5</sup>, Korea's GDP per capita in 1962 was \$US 1849. From 1954 until 1968, Korea's budget (excluding grant revenues) and current account were in chronic deficit (for instance 6% and 12% of GDP in 1962 respectively). These deficits were largely financed by grants from the US. Korea's economic structure, like the EAC today, comprised a large agrarian sector, but was less industrialized and had lower levels of trade. Agriculture contributed to 36% of GDP in 1962, against 30% in the EAC in 2005<sup>6</sup>. Industrial output contributed to only 17% of GDP in 1962, against 26% in the EAC in 2005<sup>7</sup>. In addition, the level of trade (exports + imports) in Korea was 21% of GDP in 1962, against 59% in EAC in 2007<sup>8</sup>.
- 2.2.3 Differences emerge on social dimensions. Health indicators were similar, but education levels were much higher. Life expectancy was 55 years in 1962, against 54 in the EAC in 2007<sup>9</sup>. However, gross secondary school enrollment was 42% in 1971<sup>10</sup>, against 35% in the EAC in 2007<sup>11</sup>.
- 2.2.4 Moreover, Koreans had developed a culture of tax evasion, which became widespread under the Japanese occupation as a form of resistance, but continued after the end of the colonization. Notwithstanding this reality, the situation after the Korean War was more complex. Korea had a tradition of centralized government was centuries old. Taxation systems, from the Three Kingdoms Era dating back from 54 BC, had evolved into advanced systems of delegation of powers to, and control of, the local level. This system was severely affected by the Japanese colonization and the Korean War. However, it would be fair to assume that institutions that were centuries old were able to survive to some extent and provide a starting base for a new Government, including the tax administration. In addition, during the takeoff phase, Korea was united by national sentiment, carried by a relatively united people and fueled with an urge to catch up with Japan, which helped create a culture of tax adherence and national savings.

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<sup>5</sup> The benchmark year 2005 was chosen as a reference year in this section because the World Development Indicators (WDI) database – our main source for PPP GDP at constant value - PPP exchange rates are available for this year only. In interpreting these PPP and inflation adjusted figures, one should bear in mind that inflation adjustments over long periods of time – here five decades – are subject to significant inaccuracies, especially when the structure of economies have changed significantly, as it is the case for Korea. Inaccuracies are caused in particular by the significant changes which occur over long periods in the basket of reference goods and services used to calculate inflation.

<sup>6</sup> WDI, data missing for some EAC countries after 2005

<sup>7</sup> WDI, data missing for some EAC countries after 2005

<sup>8</sup> WDI, data missing for some EAC countries after 2007

<sup>9</sup> WDI, population-weighted average, data missing for some EAC countries after 2007

<sup>10</sup> WDI. No data is available before 1971, and no other education than secondary school enrollment indicator could be found.

<sup>11</sup> WDI, population-weighted average, data missing for some EAC countries after 2007



2.2.5 The global environment in several respects was more favorable than it is today. Global demand was strong and trade growing rapidly. International competition was not as fierce as today and Korea could better take advantage of its low wages than Africa today, which is competing with China and India. Korea was not bound by many trade agreements or regional tariff structure as many African countries are today, and therefore had much more freedom to negotiate its trade policies. On the other hand, many African countries can benefit from increasingly integrated regional markets, offering markets that are significantly larger than the domestic market of Korea at the time. Importantly, the digital revolution is offering African countries many opportunities to increase productivity, including in the taxation area, that Korea did not have at the time.

### 3 Korea's tax experience

#### 3.1 Overview

- 3.1.1 In this section, Korea's tax reforms are set out chronologically, presenting at each phase policies and administrative reforms. This section is mostly descriptive, while the analysis is developed in section 4. It starts with an overview, followed with a detailed presentation by sub-period, focusing on the takeoff period – 1960s and 1970s. However, some basic information on Korea's taxation from the 1980s to today is also provided, to the extent it helps understand the reforms of the takeoff period as part of a longer term sequence of reforms.
- 3.1.2 The beginning of Korea's modern tax system is often dated back to 1948, when North and South Korea were separated. However, a major disruption occurred with the Korean War (1950-1953), which brought a special tax system designed to finance the war mainly relying on land taxation. Because the tax system created in 1948 did not have the time to mature until the end of the war in 1953, this overview starts from 1953.
- 3.1.3 The history of Korea's taxation can be broken down into two periods which mirror the economic policies at the time:
- **1953-1980 Fiscal balance and growth**
  - **1980-present Allocative efficiency and equity**
- 3.1.4 During the fiscal balance and growth period, after a slow start until 1962, Korea's economy and tax revenues grew tremendously. Between 1953 and 1962, the focus was on moving from a war to a civilian tax system and increasing Government revenues. However, central tax revenues remained volatile around an average of 7 to 8% of GDP. In 1962, one year after President Park Chung Hee took power, and as part of the first Five Year Economic Development Plan, the first comprehensive tax reform was undertaken, with tax considered for the first time as an important tool to stimulate growth. 1966 is another major milestone, as the National Tax Service (NTS)<sup>12</sup> was created as an independent administration in charge of collecting taxes. In 1970, the Korea Customs Service (KCS) was also established as an independent organization, with the mission to collect tariffs but also to provide first class services in response to growing trade volumes. The creation of NTS marked the beginning of a rapid growth in revenues. From then, central tax revenues increased dramatically from 9% to reach around 15% in 1980 (7% to 11% for domestic taxes alone). Over the same period, government expenditures were reduced from an average of 20% of GDP to 15%, achieving fiscal balance.

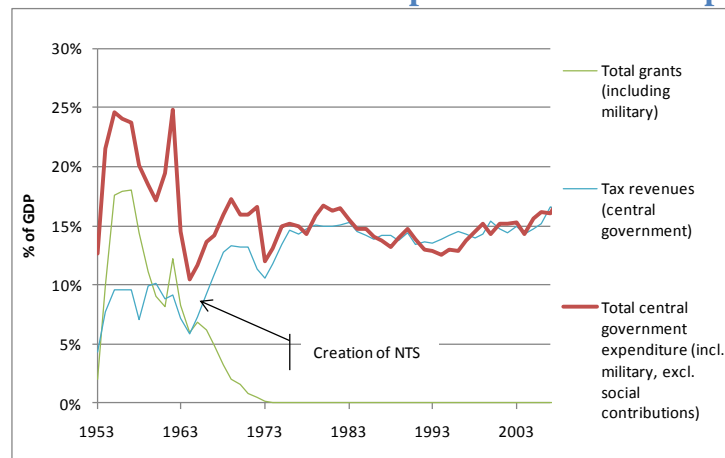
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<sup>12</sup> At first, it was called the Office of the National Tax Administration (ONTA) and then the National Tax Administration (NTA).

As inflation started to increase following the 1973 oil crisis, equity measures were introduced in 1974, including tax-based safety nets and the comprehensive income tax. Equity measures were then improved and mainstreamed during from the 1980s. Importantly, VAT was introduced in 1976.

- 3.1.5 From 1980, along with the national strategy, tax policies shifted to liberalization in order to minimize distortions and ensure equity. Taxes became more neutral and the focus was on maintaining fiscal balance and further broadening the tax base by curtailing exemptions, and equity.

**Figure 2: Central tax revenues and expenditures over the past 50 years**

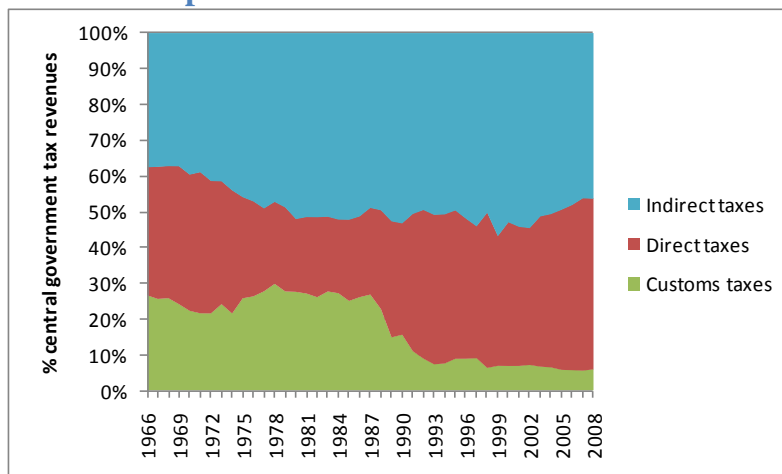


**Source: MOSF, NTS, WDI, calculations by the authors**

- 3.1.6 An analysis of the composition of tax revenues shows that Korea has heavily relied on indirect taxes, significantly more than international benchmarks. Indirect taxes progressively increased from about 45 to 55% of total taxes, against an average of 32% in OECD countries in 2005<sup>13</sup>. The progressive increase of the share of indirect taxes was initiated in 1960, during the so-called tax reforms of the Democratic Party. The thinking then was that in a low income country, indirect taxes were easier to collect.

<sup>13</sup> OECD (2007)

**Graph 1: Breakdown of central taxes**



**Source: NTS, calculations by the authors**

- 3.1.7 Second, customs taxes were designed to promote strategic export sectors during the 1960s/1970s, and dramatically reduced from the 1980s as a result of the liberalization of the economy. Customs revenue was consistently just below about 30% of central government revenues from the 1960s through the 1970s and until about the mid-80s. During the takeoff period of the economy, in order to support infant industries, import tariffs were removed or significantly reduced on imports of inputs to key and strategic industries. Similarly, export tariffs were reduced for exports of the same industries. Furthermore, import tariffs were raised to protect the domestic market from foreign competitors in the priority industries. The reduction in customs taxes in the mid-1980s was driven by the liberalization of trade. From about the mid-80s, customs revenue has fallen as a share of total central government revenue to about 8%. This resulted from reductions in customs tax rates. Direct taxes increased from 1989 to compensate for the loss in customs tax revenues. This increase was largely driven by two reforms. A more comprehensive income tax system was introduced, including financial revenues. In addition, the Government introduced taxes on real estate gains in 1990 in order to curb rising speculation.
- 3.1.8 Measures to improve the performance of customs taxes and local taxes are not discussed further in this paper. Customs taxes are not covered in detail because the integration process of the EAC and international trade agreements results in a reduction of the importance of customs taxes in the revenue composition of EAC countries. In addition, local taxes are not discussed because they remained at relatively low levels during the 1960s and 1970s. Indeed, up until 1987, the share of local taxes was consistently around 10% of total taxes (1% of GDP). However, it is worthwhile noting that local taxes have played an increasing role in financing

public services from the 1980s<sup>14</sup>. The basic information provided above aimed at giving a sense of the relative contribution central domestic taxes to total revenues.

## **3.2 1953-66: Improving policies and laws**

- 3.2.1 From 1953 to 1966, the central objective was to increase tax revenues and promote export-led growth. Following the end of the Korean War, attempts to increase tax revenues took many different forms. New taxes were introduced, such as the Education tax (a surtax on income tax), the asset revaluation tax and the foreign exchange tax in 1958. It is in 1960 that the strategy to raise indirect tax rates and reduce direct taxes was introduced for the first time, as indirect taxes were considered easier to collect in a poor country with a large informal sector. This resulted in indirect taxes contributing a prominent share of the tax revenues in Korea, a feature that still prevails today.
- 3.2.2 For the first time during this period, tax incentives aiming at supporting growth were introduced. In 1960, tax exemptions were introduced to support export, investment and SMEs in key industries. For instance, a 30% corporate tax rate exemption was granted to export businesses. It is however only in 1961, when President Park Chung Hee took power, that tax incentives for growth took a truly central role. President Park created the Economic Planning Board, in charge of defining 5-year Economic Development Plans (EDP). Tax reforms, as all the other policy tools were integrated in the EDPs and designed to achieve its goals. The first 5 year EDP focused on export manufacturing. As a consequence, 10 tax laws were revised to introduce a complete system of incentives. It included a drastic reduction of the taxation of capital, tariffs on inputs, and income in “Key and strategic industries” and export industries. A 50% exemption on income tax was granted to all foreign exchange earning businesses. Machinery and equipment directly employed for foreign exchange earning activities benefited from a special depreciation at rates 30% higher than the standard rates. Tax on interest income was close to zero to encourage savings. In addition, corporate taxes were greater for open listed companies than for closely held companies, to increase investment

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<sup>14</sup> In 1988 the share of local taxes to total taxes suddenly increased to about 14%, to progressively reach just over 20% of total taxes in 2006 (5% of GDP) (Choi, 2008). This can be compared to the average of the share of local taxes in other OECD countries, which is 13.8% (Kim, 2005). The suddenly increase in 1987 was driven by a new excessive land holding tax to help curb land speculation, and which was administrated locally. In 1989 this ratio then increased to around 20%, due the tobacco sales tax being changed from a national to local tax. This seems to have been part of the preparations, in 1989, for an election campaign, whereby the tobacco sales tax was changed to a local tax in order to become a major source of revenue for local governments. This has indeed been the case, with the reallocation of the tobacco tax providing local governments with an additional 39.8% of tax revenues in 1989 (Choi & Hyun, 1997).

opportunities through capital markets. Box 1 provides an overview of tax incentives used by Korea and of some of their improvements over time.

- 3.2.3 The Park Administration also introduced a number of reforms aimed at improving administrative efficiency. There were attempts to simplify the tax administration - such as absorbing the textile tax into the commodity tax in 1953, streamline the functioning of regional tax offices, and tax officials were screened to keep the best performing staff.

**Box 1: Summary of tax incentives during the takeoff phase and continuous improvement**

Summary of tax incentives for growth		
	Incentive	Effect
Incentives to increase savings	Reduced tax on interest, dividends and capital gains	Increases returns from savings
	Special Consumption Tax on luxury goods	Reduces the opportunity cost of saving
	Reduced income tax on listed companies	Increases the demand for savings hence interest rates
	Greater share of consumption tax in the tax mix	Increases the cost of consumption
Incentives to increase investment in priority sectors	Income tax reduction	Increases Return On Investment (ROI)
	VAT exemption on export products	Increases ROI
	Accelerated depreciation	Increases ROI
	Investment tax credit	Increases ROI
	Reduced taxes on inputs for export industries	Increases ROI

Source: consolidated by the authors from various sources

Though the incentives introduced in the early 60s remained the same throughout Korea's takeoff phase, their design was improved frequently until the liberalization period, in part to address issues with firms abusing these preferential treatments. In trying to learn from Korea's experience, it is therefore important to understand the reasons for the changes in the design of incentives and make sure that mistakes are not repeated. We highlight here three changes in the design of tax incentives that are particularly insightful.

First, in 1967, the accelerated depreciation incentive was improved to provide benefits that are proportional to the actual share of exports in a company's sales. Indeed, export companies would initially qualify for accelerated depreciation, regardless of how much they would export. This resulted in abuses, with companies registering as exporters even with very small shares of exports. Making the extent of the accelerated depreciation proportional to the share of exports solved his issue.

Second, in 1974, key and strategic industries were given the choice between three types of incentives: tax holidays, investment tax credit, and special depreciation. Tax holidays consisted in 100% exemption over the first 3 years, then 50% for two years. The investment tax credit was 8% on foreign capital goods, 10% on domestic capital goods. A special depreciation on 100% of asset value was also offered. This was decided after a decade of trying different tax incentives. This approach was probably a clever way to let the market choose what incentive was best for each type of industry, rather than the government trying to guess so.

Third, again in 1974, all incentives were unified under one law: "Tax exemption and reduction control law". This was probably a way to improve the transparency of the incentive system, and hence eliminate duplications and reduce abuses.

- 3.2.4 Though growth did start in 1963, with a growth rate of 9.3% which was later sustained, tax revenue performance fell short of expectations, remaining at around

7% of GDP. The Park administration analyzed the reasons for the failure which led them, from 1966, to refocus their approach from tax policy reforms to their implementation.

### **3.3 1966-74: Focusing on implementation**

Tax incentives continued to be used extensively during this period and the following one (chapter 3.4). But they are not developed further because, as most other policies, they did not change in nature following their creation during the first 5-year EDPs. Most tax incentives were introduced in the previous EDP<sup>15</sup>. The subsequent changes only concerned the sectors to which they applied and the rates of exemptions, reflecting changes in the sectors which were given priority. In addition, their design was improved. These improvements have been summarized in Box 1.

The key reform of this period was the establishment in 1966 of the National Tax Service (NTS, called Office of National Taxation at the time) in order to dramatically reinforce tax administration. NTS was created as an independent government agency, with the mission to assess and collect direct and indirect central domestic taxes. Before its creation, these functions were carried out by the Tax Bureau of the Ministry of Finance. The Tax Bureau remained responsible for formulating tax policies and drafting tax laws.

Many analysts interpreted the disappointing performance of the previous policy-focused reforms as a result of weak implementation and recommended the creation of a tax administration with strong capacity. After significant tax reforms in 1961, a comprehensive tax reform in 1962 and numerous other tax reforms until 1965 tax revenues grew less than the economy and remained very volatile. In 1954, the Nathan Report on tax policy suggested that the improvements in tax investigation and collection would be imperative to increase tax revenues (KDB, 1954). In 1964, the Economic Planning Bureau (EPB) recommended the creation of an independent tax agency. In 1965, during his mission to Korea as a member of the Nathan economic advisor, R.A. Musgrave from Harvard University also emphasized the need to establish a tax agency focused on fighting tax evasion (NTS, 1986).

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<sup>15</sup> One exception is the investment tax credit which was introduced in 1968.

Subsequently, President Park formed a Special Investigation Team, with the mission to assess the potential revenue increase from a fully capacitated administration. The team was created in September 1965. It was led by a secretary reporting directly to him (Mr. Lee, Nak-Sun). It comprised 12 staff from the office of the President (the Blue House), the Board of Audit and Inspection and the prosecution service. It was an excellent combination of political leadership, professional expertise and investigation power. The President entrusted the team with full powers to conduct tax investigation, and provided the team leader with a mission letter saying: “all executive and investigating authorities as well as all chiefs of state and local government agencies must comply with the team's requests related to its duty.” (KIPF, 1997).

The results of the investigation convinced President Park of the benefits of creating the National Tax Service. The Special Investigation Team decided to focus on the textile industry as an example. It was chosen because of its complex value chain, which provided a many opportunities for tax evasion. By the end of the year, the Special Investigation Team had uncovered tax evasions worth US\$ 9.3 million in this industry only. Though the investigations concerned a small fraction of the economy only, the amount of evasion uncovered was very substantial, at almost 5% of the total tax revenues collected in 1965 (US\$ 205 million). The President was satisfied that these results proved that tax revenues could increase substantially by strengthening the tax administration and immediately created the National Tax Service (NTS).

**The implementation of the NTS relied on the following principles:**

- Full top down accountability
- Full empowerment
- Dramatic strengthening of enforcement capacity
- Promoting voluntary compliance
- Increasing legitimacy

### **3.3.1 Full top down accountability**

The President made a strong public and personal commitment to meeting revenue mobilization objectives. He appointed Mr. Lee, the head of the Special Investigation Team whom had won his confidence, as the Commissioner of NTS. He was in the process making him fully accountable for his recommendations. President Park set targets based on the recommendations of the Special Investigation Team, and personally monitored results. One anecdotal evidence best illustrates how serious the level of commitment from the President was. Confident with the high potential of taxation, in 1966, President Park requested NTS to collect the tax revenues of KRW 70 billion (US\$ 258 million), an amount 30% greater than revenues in the previous year and which many thought to be over



ambitious. As a symbolic gesture of his resolve, President Park changed both his car plate number and telephone number for “700”<sup>16</sup> (KIPF, 1997). Eventually, the Commissioner met the target.

In addition, a chain of targets called the target revenue approach were set at all levels of the organization, from the Commissioner of NTS, to the heads of Regional Tax Offices, to the heads of District Tax Offices, to the division managers, down to the tax officers. These tax targets were broken down by geographical areas and tax categories. Monetary incentives for incentives were introduced at all levels, under the form of bonuses and penalties for outperformance and underperformance

The President made a public commitment to implement a zero tolerance policy for corruption. He explicitly pointed out that repairing the shame and blame of the past resulting from corruption was one of the main objectives of the creation of the NTS. A clear and strict rule established that whoever was involved in corruption would be fired and punished. This rule was enforced by a special anti-corruption team of 20 young, competitive and committed government officials, who were selected through the Senior Government Official Examination. To increase their visibility, they used to wear blue neckties and their slogan was an old Korean proverb saying “Treat gold as stone”. The fight against corruption also targeted bribers. In the first years of President Park in power, 24 leading business men were arrested for corruption<sup>17</sup>.

### **3.3.2 Full empowerment**

Such stringent accountability system would not be successful without a commensurate empowerment. NTS benefited from full empowerment under two forms: political and financial.

First, NTS benefited from the full political support by the President. The Commissioner, as a result of NTS’s intensive investigations, faced high levels of pressure including from people with powerful political connections. But the President confirmed his indefectible support in many instances.

Second, NTS was given resources to dramatically increase its size and capability. From 1966 to 1969, in 3 years, its budget increased by 71% in real terms, and its number of staff per inhabitant by 57%. Headcount went from 5500 to 9247, hence an increase by 3747 staff. The increase benefited both headquarters and local offices. As can see in the following, a substantial part of these resources were used to strengthen the administration’s enforcement capacity.

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<sup>16</sup> In Korea, there is a unit which is worth 0.1 billion. 70 billion is therefore equivalent to 700 of this unit.

<sup>17</sup> See [www.sjsu.edu/faculty/watkins/park.htm](http://www.sjsu.edu/faculty/watkins/park.htm)

### 3.3.3 Dramatic strengthening of enforcement

First, research functions were significantly strengthened. The functions of research are of course not limited to enforcement only. Research can be used to assess the impact of tax policies on equity, or on competitiveness for instance. We focus here on two research functions that are critical for enforcement: the assessment of revenue targets at a macro level and at the tax payer level. If properly conducted, these two research functions helps ensure targets are realistic and that the appropriate taxpayers are identified for investigation. NTS' research department extensively developed and used *differential tax payer management systems*. They consist in cross-checking all sources of information available – including sector level surveys, individual reports - of tax payers to categorize them into degrees of presumed compliance. High income earners categorized in the low degrees of presumed compliance would be targeted in priority for in-depth investigation. In addition, to secure highly qualified and fully committed tax officials, *the National Tax Officials Training Institute* was established in 1967.<sup>18</sup> In 1968, the institute had 88 staff. *Information Technology* was introduced in the very early days, in 1970, to facilitate the processing of large amounts of information. NTS installed computer equipments and started to train in-house IT specialists. The strong IT support also enabled the introduction of the General Income Tax in 1975 and VAT in 1977, which involve heavy processing of income and transaction data (KIPF, 1997).

Second, NTS dramatically strengthened its capacity to conduct on-site investigations. Before the creation of NTS, the division responsible for on-site investigations within the Ministry of Finance was also responsible for other tasks, such as staff performance evaluations. It was not possible to carry out intensive tax investigations until NTS was created, with one investigation division at headquarters, and one investigation division in each field office. Investigations were sequenced in campaigns, each with its own focus. For instance, in 1966 the focus was on high income earners. In 1969, the focus changed to tax payers with a poor reporting record. Each campaign was carefully prepared by intensive data analysis and field surveys.

Third, NTS heavily invested in decentralization. Between 1966 and 1968, the number of staff in district tax offices increased from 4906 to 8033, which represents a 64% increase. Research teams were created in each local tax office. Investigation teams were reinforced. At its creation, NTS had 4 Regional Tax Offices, 77 District Tax Offices. In its first two years, two new Regional Tax Offices and 14 District Tax Offices were added.

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<sup>18</sup> It was then replaced by the National Tax University in 1980 (up to 2001) of which all graduates were employed by NTS.

Fourth, NTS enforced for small businesses a policy of full registration and simplified tax filing. *One registration was required for each business location.* This system lasted until 2008, when registration by business unit (with one consolidated balance sheet) became required for every business. Given the geographical nature of the full registration policy, local offices were in charge of enforcing it. Relevant regional or district tax offices were in charge of ensuring that all businesses were registered and of all the subsequent steps of the tax cycle, including collecting returns, payments, investigation. Full registration would not have yielded results had the small businesses been requested to submit tax returns based on bookkeeping and tax invoices. Instead, *small businesses were simply required to pay tax calculated with the Standard Assessment Method.* The Standard Assessment Method has been widely used in Korea for both income tax and sales taxes, later replaced by the VAT. The Standard Assessment Method estimates income and sales based on a series of objective and easy-to-observe measures. These can be for instance the number staff or machines. Ratios based on these measures and defined in a Standard assessment guide were then used by tax officials to determine the base for calculating taxes, either gross sales in the case of sales tax or gross income in the case of income tax. Tax payers were given the option to file full returns to determine their taxes if they felt they would pay less taxes (Choi, 1990).

### **3.3.4 Promoting voluntary compliance**

Many efforts were directed towards encouraging voluntary and faithful tax submissions and registration of tax payers. As system of incentives was put in place to reward tax payers using transparent reporting methods and penalize those who were not.

The “Green Report System”, established in 1965, was the Government’s first effort to introduce the voluntary self assessment system. Once a taxpayer was found to be a green reporter as a result of faithful reporting, he was granted preferential treatments, such as tax deductions and installment payments. As an illustration, one of the criteria for becoming a green reporter was that field investigations would confirm earnings within +/-5% of the amount originally reported. However, some green reporters exploited the system to evade tax. As a result, from 1968, additional control measures were taken such as field investigations of green reporters.<sup>19</sup>

NTS also made substantial efforts to encourage bookkeeping, as a way to increase compliance and accuracy of tax submissions. These efforts started in 1966 but were sustained on the long run, until today. The number of taxpayers using

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<sup>19</sup> The Green Report System prevailed until the full introduction of voluntary self assessment system of income tax in 1995.

bookkeeping was 5163 in 1966. It was 219,000 in 1987 (33.2% of Global Income Taxpayers<sup>20</sup>) and 1,585,000 in 2007 (54.7% of Global Income Taxpayers). From 1966, NTS held *bookkeeping seminars* for various types of businesses and conducted *promotion campaigns* through mass media to encourage bookkeeping. In 1972, *Regional Tax Offices and District Tax Offices were given the responsibility to actively guide tax payers* on double-entry bookkeeping and single-entry bookkeeping techniques. Since 1985, NTS established and managed a *database of target taxpayers to be actively guided on bookkeeping*. NTS created and distributed a *simplified bookkeeping form* in 1999. In 2004, *tax rates were raised for negligent bookkeepers*. *Certificated Tax Attorneys (CTA) were trained to help taxpayers* – mainly personal taxpayers and small businesses – produce compliant books, tax returns and payment claims. In 2007, a total of 7,260 CTAs were registered.

### 3.3.5 Increasing legitimacy

As enforcement was given a strong emphasis, it was critical at the same time to increase the legitimacy of taxation. The main measures taken to this end were as follows.

The zero tolerance policy for corruption played an important role in increasing the legitimacy of taxation. As explained in chapter 3.3.1, the President publicly committed to eradicate corruption and set up very visible anti-corruption measures. This was important as tax payers had initially a negative image of tax officials because of widespread corruption. Interestingly, it is reported that as their image improved, the morale of the tax officials also improved.

Public education and relations were also given an important role. In 1967, the Tax Day was set for March 3 every year, to promote a clean image of tax administration, create awareness of the central role of taxation in meeting the nation's development goals, and encourage self-compliance. The event was chaired by President Park himself. Some of the interesting features of this tax day were the award of prizes for the best taxpayer and the involvement of national celebrities. The Tax Day still exists today<sup>21</sup>. In addition, as part of the public relation building effort, a Woman volleyball team sponsored by NTS was created.

A greater emphasis was also put on improving the fairness of taxation. This involved *improving the accuracy of the Standard Assessment Method (see chapter 3.3.3)*. The Standard Assessment Method was very basic at the beginning, and became gradually more sophisticated. At the creation of NTS, research teams in Regional Tax Offices undertook a revision of the ratios of the Standard assessment based on field surveys of reference businesses. Subsequently, in 1975, a multi-stakeholder group was set up to revise the guidelines, including tax administrators, tax specialists, representatives from the business community and financial institutions. In 1978, the method was adjusted based on geographic considerations and business cycles were taken into

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<sup>20</sup> Global Income Tax was introduced in 1974.

<sup>21</sup> In 2010, four show business Korean stars were appointed goodwill ambassadors. See [http://english.chosun.com/site/data/html\\_dir/2010/06/01/2010060101043.html](http://english.chosun.com/site/data/html_dir/2010/06/01/2010060101043.html)

account. In 1981, the standard ratios also reflected many other factors, such as the amount of capital, the type of facility, the business reputation and so on.

### 3.4 1974-80: Strengthening equity and introducing the VAT

The main features of the tax reforms of this period are the strengthening of equity as an objective of taxation, and the introduction of the VAT.

#### 3.4.1 Strengthening equity

Following the 1973 oil crisis, the equity objective became more important. Korea experienced two years of lower growth: 7.2% in 1973 and 5.9% in 1975, as opposed to an average of 9.3% from 1963 to 1971. Growth came back to 10.6% in 1976, but inflation remained high (33, 26 and 25% from 1974 to 1976, while it had remained below 18% since 1965), eroding the purchasing power of the poorest.

As part of the effort to improve progressivity, and broaden the tax base among the wealthier, the Comprehensive Personal Income Tax was introduced. Until 1966, individual income was taxed at a flat rate by income categories. The first significant step toward global taxation was taken in the 1967 tax reform, which introduced a progressive income tax based on comprehensive income. However, the comprehensive income was rather narrowly defined and the income tax system continued to be better approximated by flat taxes on various income categories, rather than by a progressive tax based on a broad income category. The definition of comprehensive income was broadened subsequently, in particular, by the tax reform of 1974 (effective 1975), which introduced the basic framework of the current individual income tax system (Choi, 2004). Under the comprehensive income tax system, the number of tax brackets increased and the highest marginal tax rate was raised to 70 percent in 1975 from 50 percent in 1970.

Table 1: The Structure of the Personal Income Tax

	Number of brackets	Lower rate	Highest rate
1970	9	7%	50%
1975	16	8%	70%
1980	17	6%	79%

Source: Choi (2004)

In addition, the government granted generous tax reliefs to low wage earner. The level of tax-free personal deduction rose from 120,000 KW in 1970 to 780,000 KW in 1975, then to 2,380,000 KW in 1980. Various deductions and credits were newly introduced. In addition to personal deductions, a wage earner was eligible for several other deductions, such as labor income deduction and deductions of educational and medical expenses.

Finally, in 1974, the National Tax Tribunal was established as an independent agency to handle tax appeals under the new Basic Law of National Taxes. By protecting taxpayers' rights, the Tribunal contributed to improving both equity and legitimacy of taxation.

### 3.4.2 Introducing the VAT

The value-added tax (VAT) was introduced in Korea in 1977, after legislation was passed in late 1976. One purpose was to streamline the indirect tax system and its administration. Eight indirect taxes were consolidated into the VAT and a special consumption tax (SPC).

The VAT was also adopted to introduce greater neutrality into the indirect tax system. The previous cascade turnover tax system had a number of resource misallocation and inefficiency disadvantages including: encouraging vertical integration and penalizing specialization, because the reduction of inter-firm sales reduced total tax liabilities.

In addition, the VAT aimed at promoting exports and capital formation. In order to promote *exports* they were zero rated at the final stage of production under VAT, and rebates were available on taxes paid at earlier stages of production. This was in contrast to the previous system where cumulative taxes at “earlier stages of transactions in exported goods were either not rebatable or merely partly refundable”.<sup>22</sup> Unlike most of the taxes it replaced, VAT does not burden *capital goods* because the consumption-type VAT provides full credit for the tax included in the purchase of capital goods<sup>23</sup>. As a result, VAT was expected to encourage *capital formation*.

VAT was introduced and imposed at a single 10% rate on a wide range of goods and services, and collected through the invoice method. Thereby, each firm collected VAT on all sales, unless they were exempt, and were then entitled to a credit against its liability for taxes invoiced by its suppliers. Activities exempted from VAT included: exports (zero rated), daily necessities such as unprocessed foodstuffs and tap water, and financial services. One beneficial feature introduced with VAT was a change to a quarterly payment, which was easier for businesses to comply with than the more frequent two month tax period used under the old business sales tax system.

A special consumption tax (SPC) was introduced simultaneously with VAT to inject some progressivity into the indirect tax system. The SPC imposed higher taxes on goods and services consumed disproportionately by high income

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<sup>22</sup> Choi (2008)

<sup>23</sup> The credit does not subsidise the purchase of capital goods, it simply eliminates the tax that had been imposed.

groups<sup>24</sup>. In addition, a number of exemptions were also used to reduce the regressivity of the VAT burden.

Although Korea adopted a single 10% VAT rate, small businesses received special treatment, whereby if their annual sales were below a certain amount (KRW 24 million when VAT was first introduced, or US\$ 50,000) they were taxed at a rate of 2% of turnover. The special treatment for small business tended to be abused because small businesses were prone to under-report their turnover. Up to 1985, special taxpayers filed about 70-80% of all VAT returns with general tax payers filing the rest. However, although in the minority, general taxpayers contributed by far the majority of revenue (generally about 95% or more). Thus, the government has made continuous efforts to reduce special taxpayers by freezing criteria for special taxpayers. It has also tried to expose transactions as much as possible with various measures such as increasing the use of credit cards and introducing the cash receipts system (see Box 2). As result of these efforts, the proportion of special taxpayers decreased below 40% by 2006.

**Box 2 : Cash-Receipts – A recent innovation using technology and incentives to further broaden the tax base**

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<sup>24</sup> These included Televisions, refrigerators, pianos, passenger cars, coke, coffee, and - quite surprisingly given the intention of progressivity - sugar.

Like many other countries across the globe, Korea has faced difficulties in accurately identifying tax revenues from small-sized businesses, especially since the Korean public tends to prefer paying in cash and fails to attach much significance to receipts. In 2000, credit-card purchases accounted for only 25.5 percent of total private spending. In a drive to levy standardized taxes on small businesses, the government has, since 2000, tried to stimulate public use of credit cards. It has expanded the number of businesses accepting credit cards, showered gifts on raffle winners drawn from the pool of credit-card users every month, and offered tax deductions for credit card purchases. As a result, credit card payments expanded to 41.7 percent of the nation's total private spending in 2004, contributing to improving the transaction transparency and pinning down tax sources. Yet, cash transactions still make up 50 percent of total private expenditures. As a way to address this problem, Korea has introduced the world's first-ever cash-receipt system in 2005.

The cash-receipt system is a program through which cash purchases are tracked by a customer presenting a membership card for the system or a cell phone number, as opposed to getting a regular receipt, which is a record of sale for use by the buyer and the seller. When this cash receipt information is entered after a cash purchase, the information is sent straight to the National Tax Service. Thus, the government began the cash receipt system, through which cash incentives are offered to consumers to help track taxable transactions. The threshold for registering transactions stood at 5,000 Korean won (\$3.75) until June 2008, when it changed to 1 Korean won beginning in July of that same year. The individual main taxpayer is able to receive a 20-percent deduction on his/her year-end tax settlement on the amount of total cash spending that exceeds 20 percent of one's reported yearly income, up to a total of 5 million won. For businesses, a 1 percent rate of applicability is in place. As of 2007, the number of cash receipt issuances has surpassed the 700-million mark, while 1.37 million businesses are registered cash-receipt issuers.

Source: Korean Government Official Website (Korea.net), NTS

The Korean government expanded and retrained the tax administration personnel. The number of staff at NTS increased from 9,443 in 1976 to 11,442 in 1977. The new recruits did not begin working with VAT straight away and, instead, were put into other sections in order to release more experienced staff for VAT administration. This was complemented by staff handbooks prepared by NTS for officials working on VAT.

The success of VAT largely depended on the degree of voluntary cooperation from the business community. In order to build this support and allow for business input, the Government set up committees, which included representatives from the Chamber of Commerce, Korean Tax Accountants Association and other relevant institutions. Despite these efforts, "insufficient communication between the government and taxpayer organizations and consumer groups damaged prospects for close cooperation. Unhappiness with the VAT on the part of the business



community was evidenced by its last minute call to postpone the implementation of the VAT before the VAT became effective.”<sup>25</sup>

A decentralized regional responsibility system was put in place. NTS has considered registration by operation important since VAT is in principle imposed per place of business. In this light, VAT tax administration – assessment, collection and investigation – has been conducted mainly under the responsibility of relevant regional or district tax offices. Initially, VAT tax officers were specified for each area where they were responsible for almost all taxation procedures including: business registration, tax returns and payment, investigation, and tax base development. In addition, the regional officers were responsible for reviewing the contents of tax reports and providing guidance before they accepted the reports to ensure faithful tax compliance and early settlement of VAT.

From its first year of introduction, a computerized system was put in place to cross-check seller and purchaser invoices of general tax payers. In the last half of 1977, 7.2% of all invoices did not match, but in 1982, the proportion of mismatches decreased to 1.4%. Improved compliance enabled the administration to progressively decrease the number tax invoices processed.<sup>26</sup>

### ***3.5 1980-today: Liberalization***

**From the 80s, in keeping with a policy of structural adjustment and liberalization, tax reform activities slowed down.**

**The focus was on reducing the range of tax incentives and broadening the tax base to improve allocation efficiency.** In 1982, the liberal tax privileges of strategic industries were almost completely removed. The 1988 tax reform significantly reduced remaining exemptions. This effort has continued since, with for instance the 1998 reform which removed VAT exemptions on professional services such as lawyers and accountants. In 1993, the real-name system of financial transactions included tax on capital income into the individual tax base, completing the efforts of the 1976 comprehensive income tax to improve progressivity.

**In addition, a number of ad-hoc revisions of tax policies were introduced to address new issues as they arose.**

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<sup>25</sup> Choi (2008)

<sup>26</sup> Choi (2008)

**To curb real estate speculation the excessive land holding tax in the 1986 significantly increased land related taxes.** These included taxes on capital gains and land property. These measures have often been viewed as ineffective, in part due to their not being comprehensive and hence not the creating enough incentives for the wealthiest to reduce speculation<sup>27</sup>.

**Following the 1997 Asian crisis, it became critical to rapidly restructure inefficient chaebols.** Tax incentives were granted to transaction-related taxes such as capital gains tax, acquisition tax, and registration tax. For instance, corporate assets after mergers and acquisitions were exempted from registration tax and made eligible from corporate income tax until the alienation of the revalued assets.

**As part of the efforts to reverse the capital flight prompted by the crisis, the Foreign Investment Promotion Law (FIPL) was enacted in 1998.** For instance, foreign businesses and investors who made advanced technology Foreign Direct Investment (FDI) in Korea were eligible for exemption from individual and corporate income taxes for the first seven years, and a 50% reduction for each of the following three years.

**One of the more recent challenges faced by Korea has been population ageing. The National Pension Fund was created in 1988 to help address this issue.** Annual contributions have grown to 7% of GDP today (see Figure 3). According to OECD simulations, Korea's public spending on health and long-term care might rise by 6 to 9 percentage points of GDP by 2050, the largest increase in the OECD area. The OECD recommends taking early action to increase revenue so as to limit the long-term cost from the higher fiscal burden<sup>28</sup>.

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<sup>27</sup> Choi (2004) p81

<sup>28</sup> Randall (2009)

## **4 Select lessons from an EAC perspective**

While the previous section provided a narrative of Korea's tax reforms during its takeoff phase, this section analyses two lessons of particular relevance to EAC member countries. First, Korea achieved faster results by focusing its tax policies on a few priorities fully aligned with its national development strategy. Second, Korea broadened its tax base by making its tax administration both empowered and accountable. One chapter is dedicated to each lesson, analyzing the results achieved and some of the key measures which contributed to them.

### **4.1 Focusing on few priorities aligned with the national development strategy**

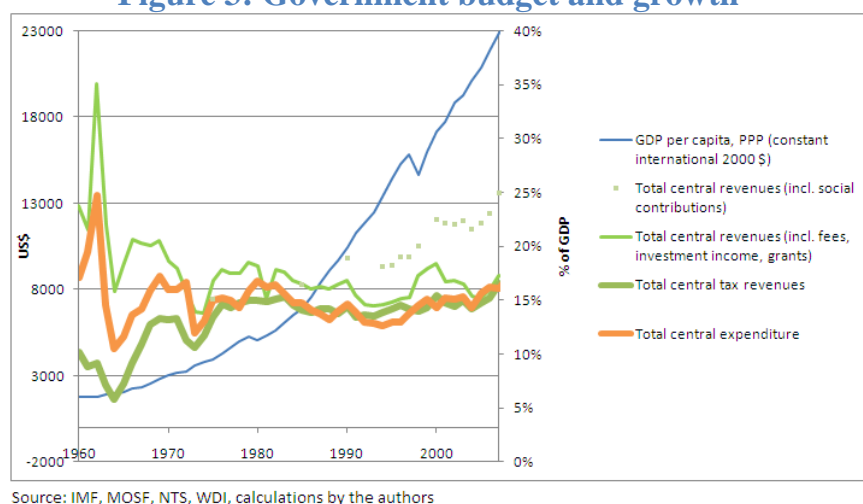
Like EAC member countries today, Korea during its takeoff was challenged by multiple and conflicting tax objectives. These included increasing revenues, allocating resources efficiently, stimulating savings and investment, providing safety nets and promoting social equity. However, stimulating investments or providing safety nets for instance involve exemptions, which unfortunately conflicts with objectives of allocating resources neutrally and broadening the tax base.

Korea focused its tax policies on a few priorities fully aligned with its national development strategy. In the 60s and 70s, Korea's national strategy was on the one hand to rapidly achieve fiscal balance at a low level of expenditure, and on the other hand to promote growth through an infant industry policy. To this end, Korea pursued tax policies focused on increasing revenues from a very low base up to a level still low by international standards, broadening the tax base, and providing incentives to strategic sectors.

The following illustrates the alignment of Korea's tax policies with three specific national strategies: small balanced budget, active export promotion, followed by liberalization. The last chapter of this section concludes by stressing the importance of an integrated economic planning process to bring the benefits of prioritization and alignment with the national strategy.

#### **4.1.1 Small and balanced government budget**

**Figure 3: Government budget and growth<sup>29</sup>**



During the takeoff period and after 1980, government budget was small by international standards, with tax revenues and expenditures below 16% (see Figure 3). Central tax revenues of 16% of GDP are in the same range as in the EAC today and much lower than in South Africa. Average tax revenues in 2008 in the EAC stood at 16%<sup>30</sup>, ranging from 12% (Uganda) to 19% (Kenya). Tax revenue was 28% in South Africa in 2008. In addition, a study by Bahl, Kim and Park (1986) compares Korea's expenditure to 31 other developing countries from 1973 to 1976, making adjustments to ensure comparability. It finds that the average expenditure share of GDP in Korea was significantly lower than in the comparator countries (15.9% vs. 28.4% including military expenditures, and 11% vs. 17.4% for nondefense expenditure).

One of the main rationales for a small government budget was to rapidly achieve fiscal balance. Achieving fiscal balance was primarily the result of an anticipated decline in foreign aid. Following the Korean War, the USA were the main provider of aid to Korea. Aid accounted for up to 45% of Government revenues

<sup>29</sup> The figure excludes local government revenues. It shows 'central tax revenues', but also 'total central revenues including tax revenues, proceeds from divestitures, investment income and grants', and 'total central revenues including the former and social contributions'. Social contributions are mostly constituted of the National Pension Fund (NPF), which is the largest public fund in Korea. It was established in 1988 and has been largely accumulating reserves since rather than making payments. As revenues including social contributions were not available every year, they are indicated in dots. The main point for this case study is that in the 60s and 70s, before the creation of the NPF, total central revenues were much lower than the EAC average and much lower than in South Africa. In addition, after the creation of the NPF, total revenues including social contributions, remained below 26% up to today, which is much lower than the OECD average of 37% today. This illustrates that Korea has continued its policy of low public expenditure.

<sup>30</sup> GDP-weighted average, calculated by the authors from IMF staff reports.

and 70% of imports. In 1957, the USA unexpectedly announced that they were phasing out their financial aid, which effectively started to decline from 1958. From that year, addressing the resulting twin deficit became a central objective of government policies. The government reduced expenditure from around 20% of GDP in the early 60s to 16% in the 70s, while tax revenues increased from 9% to 15%. Fiscal balance has been consistently achieved from the mid-70s.

The other important rationale was to encourage private investment and growth. Korea's development was fundamentally private-sector led. Though the Government very actively worked with the private sector to provide a conducive environment to achieve competitiveness, including temporary protection, targeted subsidies, adequate human resources, infrastructure, support in international sales and marketing..., production was driven by the private sector. This policy required maximizing savings available to the private sector, lowering corporate taxes to the extent possible, and encouraging private consumption. A small government budget was seen as important to achieving these objectives.

Accordingly, Korea's taxation during the takeoff phase aimed at contributing to achieving fiscal balance while maintaining a low tax burden. Fiscal balance was indeed achieved by both reducing expenditures and increasing revenues. In addition, tax revenue was capped at a low level, below 16% of GDP, which along with a broad tax base (see Chapter 4.2.1), contributed to making low tax rates possible. For example, VAT was à 10%, against 16 to 20% in the EAC. Korea's VAT rate is among the lowest in the world, while it contributed substantially to total revenues, at about a fourth of central tax revenues (25% in 1980). Furthermore, Corporate Income Tax for small and medium enterprises was also low, at 15 and 25% for listed and non-listed small enterprises respectively<sup>31</sup>, against 30 to 35% in EAC countries.

**Corporate income tax rates in 1968 for listed and non-listed companies**

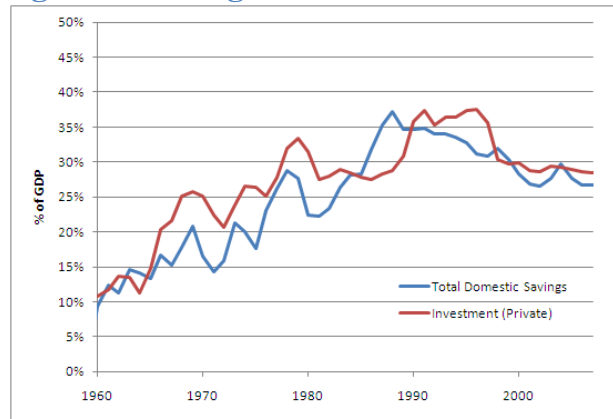
	Taxable income (KRW)		Taxable income (2000 PPP US\$) (1)		Listed	Non listed
	between	and	between	and		
Small enterprise (2)	0	1,000,000	0	41,775	15%	25%
Medium enterprise (2)	1,000,000	5,000,000	41,775	208,874	20%	35%
Large enterprise (2)	5,000,000		208,874		25%	45%

Source: K. Choi, (2004), *Tax policy and tax system in Korea*, Chapter 1 table I-8, KIPF

Notes: (1) Conversion by the author, based on WDI PPP exchange rates and CPI

<sup>31</sup> (2) Qualification of the taxable income bracket by the author

**Figure 4: Savings and investment in Korea**



Source: Bank of Korea, WDI

The small balanced budget strategy, including its tax component, contributed to a dramatic increase in domestic private savings and investment (Figure 4). Savings started at 10% of GDP in 1960 and increased dramatically to 30% in 25 years. Investment follows a similar progression, but remains greater than savings during the entire takeoff period. The gap between investment and domestic savings was mainly filled by private foreign loans, many benefitting from Government guarantee. Korea sustained an average savings ratio of 30% from the 80's, which is high compared to savings ratios in both the EAC (savings stood at 10% in 2008 in Kenya and 18% in South Africa) and advanced economies (Germany and the USA in 2005 had domestic savings ratios of 22 and 14% respectively).<sup>32</sup>

#### 4.1.2 From active export promotion to liberalization



<sup>32</sup> It is worth noting that following the decline in aid to zero in 1974, foreign capital played a significant role in the financing of Korea's development, but second to domestic savings. Foreign capital has been dominated by foreign private loans, which hovered around 7%. FDI was insignificant until 1997, when Korea opened its stock exchange to foreign investors in an attempt to reverse the capital flight triggered by the financial crisis. FDI has remained below 2%.

The sequencing and nature of Korea's tax strategies closely mirrored the sequencing of its development policies. As explained in chapter 2.1, from 1962 to 1980 Korea conducted an export-oriented infant industry policy, providing temporary protection and privileged support to selected industries. Consequently, during this period, one objective of tax policies was to promote the growth of these selected industries. Tax incentives were extensively used, as explained in chapter 3.2. Similarly, from 1980, as the national policy moved to liberalization, tax shifted to eliminating exemptions to achieve effective market-based resource allocation.

A number of studies demonstrated that tax incentives did contribute to the national strategy by increasing the financial attractiveness of investment in the priority sectors, but less than credit-based incentives. Kwack (1992) finds that over the period of 1966 to 1985, up to 37% of total investments were given back to key and strategic industries under the form of tax privileges. According to KIPF (2004), in 1970, tax exemptions amounted to 30% of total tax revenue. However, Kwack (1984), using a modified version of the effective marginal tax rate formula developed by D. W. Jorgenson and M. A. Sullivan finds that effective marginal corporate income tax rates were still high and that benefits from tax privileges were effectively lower than one would have expected<sup>33</sup>. The high levels of effective marginal tax rates are the result of high inflation and the depreciation regime based on historical costs. Finally, Kwack (1988) found that tax incentives played a role in reducing the cost of capital for export companies, but this impact was much smaller than the credit-based incentives provided by the government. For instance, in 1966, tax incentives and direct financial incentives reduced the cost of capital from 63% to 54% and 42% respectively.

#### **4.1.3 Benefits of an integrated economic planning process**

Korea could fully align its tax policies with the national strategy because it formulated both as part of integrated five-year economic development plans. The plans - Korea's central development planning tool - were developed by a small team called the Economic Planning Board, established in 1961 by President Park

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<sup>33</sup> For instance, in 1975, when the benefits were the largest, two firms producing machinery, electrical and electric equipment, one qualifying for tax privileges and the other one not, would pay an effective marginal tax rate of 53.2 and 38.7% respectively. The marginal effective tax rate on capital income is the expected pretax rate of return minus the expected after-tax rate of return on a new marginal investment, divided by the pretax rate of return. It therefore measures a reduction on rates of return. The marginal effective tax rates and the tax rate are therefore different concepts and cannot be compared directly.

and directly reporting to him. The plans encompassed all policies, including taxation, focusing them towards a few common objectives (see chapter 2.1 for more details).

The impact of tax policies was enhanced because they were complementing other policies. The list of complementary non-tax measures during the takeoff period is long and included the following: the won was devaluated in 1964 by 50%, official interest rates from deposits were raised dramatically in the mid-60's to encourage savings, credit-based subsidies were provided to key industries, preferential access to imports in the form of quotas was given to companies with strong export performance, free trade zones were established with streamlined customs procedures, public investments focused on export infrastructure such as ports, systems of centralized wholesale purchase of imported inputs were put in place to increase the bargaining power of export SMEs, high potential SMEs were selected for special support including capacity building and close government performance monitoring, ambassadors were given export sales targets and held accountable for meeting them. In the social space, special education programs were put in place to provide priority industries with the adequate skills, and active family planning brought the total fertility rate from 6.0 to 1.6 over the period 1960-87, thus facilitating capital accumulation (including human capital)<sup>34</sup>.

Furthermore, the trade-offs resulting from a strong focus in the tax area could be made up by non tax policies, illustrating that prioritization and sequencing offer a solution to overcome conflicting tax objectives. The objectives of increasing revenues and providing incentives for savings and investment in target sectors were given higher priority than others such as neutrality and equity<sup>35</sup>. However, these trade-offs were largely made up by the outcome of other policies. These, rather than direct revenue transfers, focused on providing pro-poor opportunities. They included equity-oriented expenditure programs - such as the New Village Movement which provided performance based subsidies to villages to improve

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<sup>34</sup> From 1966, the average population growth was more than two times higher in Uganda and Kenya than in Korea (source: WDI and calculations by the authors). Family planning policy in the 60s promoted small families. It contained communications campaigns including use of contraceptives. It was recognized internationally as being successful and was acclaimed by the United National Fund for Population Activities. A low population growth is likely to have played a critical role in making rapid capital accumulation possible in Korea. It also helped limit the burden on the government for the provision of public services.

<sup>35</sup> Social spending in Korea has been relatively low, below 3% until 1990. Though it has continuously grown since to reach 7% of GDP today, an OECD study observes that Korea still ranks last among OECD countries on that dimension (Randall, 2009).



productivity<sup>36</sup>, a thorough land redistribution program between 1945 and 1950, and education policies that promote upward social mobility<sup>37</sup>. These policies, combined with decades of sustained growth, enabled Korea to perform well on equity, as evidenced by Korea's Gini coefficient of 32 in 2008 - equal to the European average.

## **4.2 Empowering and holding accountable the tax administration**

Korea broadened its tax base by making its tax administration both empowered and accountable. The most visible result of creating the NTS was the subsequent rapid increase in central tax revenues, from 9% of GDP in 1966 to 15% in 1980 (7 to 11% for domestic taxes, the remaining coming from customs taxes, under the responsibility of a separate agency). Most EAC member countries have achieved revenue levels in the same range, over similar periods of time. However, at similar levels of revenues, Korea seems to have achieved a broader tax base. In the following we present evidence of Korea's relatively broader tax base and analyze the links between this performance and two distinctive features of Korea's tax system: a tax administration benefitting from adequate resources and high level political support, and at the same time fully accountable for results.

### **4.2.1 Evidence of a broadened tax base**

A number of macro-level indicators show that Korea succeeded in broadening its tax base. Micro-level indicators for the 60s and 70s, such as measures of tax productivity by type of tax cannot be calculated because of the lack of detailed data on different tax base (personal and corporate income in particular).

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<sup>36</sup> The initiative (Saemaeul Undong) was launched 1970 by South Korean president Park Chung Hee. It sought to rectify the growing disparity of the standard of living between the nation's urban centers and the small villages. It was performance-based and concentrated on building up rural infrastructure. It was hailed as a great success in the 1970s, contributing to a rapid increase in rice productivity from 2.5 to 4.5 ton/ha (among the highest in the world, on par with Japan). The movement lost momentum during the 1980s as it was plagued by several challenges, including rent capture (Kim, 2010).

<sup>37</sup> Zaghera and Shvets (2004)

### Box 3 : Drivers of tax revenue increase: number of taxpayers and size of the individual tax base

Three factors can individually drive an increase in tax revenues, all other things being equal: increase in tax rates, broadening of the tax base, or improvement in collection (in the narrow sense of effectively collection of taxes as they have been calculated). Of course, these factors can move in divergent directions and together result in either an increase or decrease in revenues. For instance, a broadening of the tax base along with a decrease in tax rates can still result in an overall increase in tax revenues.



The tax base is what is taxed. Its broadening can therefore take essentially two forms:

- *increase in the number of taxpayers*, following an improvement in the identification and registration of tax payers, a reduction of exemptions
- *increase in the individual tax base* - by tax payers -, following a reduction in evasion, a greater accuracy of the estimate of the individual tax base – either through enforcement or voluntary compliance, an

First, tax revenues increased significantly, while tax rates and collection efficiency did not, indicating that a broadening of the tax base was a key driver. Most of the revenue increase occurred in the four years following the creation of the NTS, from 1966 to 1969, with an average annual real growth rate of 25%. Our focus is therefore on these four years. Furthermore, the top four domestic taxes were individual income tax, personal income tax, business tax and commodity tax (both indirect taxes), accounted for 43% of total tax revenues in 1966, and grew at an annual real rate of 27%. We focus our analysis on these taxes.

Depending on the type of taxes, the growth in revenues was driven by either an increase in the number of taxpayers, or a broadening of the individual tax base. First, there is no indication that collection efficiency improved over the same period – in fact it might have slightly deteriorated, as arrears (ratio of arrears to tax collection) increased from 8% to 10% from 1966 to 1970. Second, Table 2 shows that changes in average tax rates were marginal, between -3 and +7%. As a result, the increase in revenues must be explained by a broadening of the tax base under the form of an increase in the number of taxpayers or broadening of the individual tax base (see

Box 3).

**Table 2: Domestic taxes: drivers of revenue growth**

**Average early average growth rate, from 1966 to 1969**

	Real revenue (1)	Average tax rate (2)	Nb. of taxpayers (1)
Personal income tax (3)	31%	7%	32%
Corporate income tax	26%	-3%	4%
Business sales tax	27%	0%	6%
Commodity tax	24%	0%	10%

Source: NTS, calculations by the authors

Notes: (1) Arithmetic average of annual growth rates

(2) the average tax rate is the average of the tax rates in each bracket.

The correct average rate should be weighted by the tax base in each bracket.

As the tax base by tax bracket was not available, the average was used as a proxy.

(3) The change in number of taxpayers is shown only for the individual business income tax

In the case of personal income tax, the increase of the number of taxpayers was one of the important drivers of the broadening of the tax base. Personal income tax revenue is composed of many different forms of personal income tax: labour income tax (employees), individual business income tax (small business owners), real estate income tax, interest income tax... Table 2 shows the growth in the number of tax payers for one of these components: the individual business income tax. It grew by a staggering 32% on average from 1966 to 1969<sup>38</sup>.

For both corporate income tax and indirect taxes, increase in the individual tax base was the main driver of the broadening of the tax base. Indeed, Table 2 shows that the number of tax payers for corporate income tax and business sales tax increased by 4 and 6% respectively, which is largely insufficient to explain a growth rate of 26 and 27% respectively.

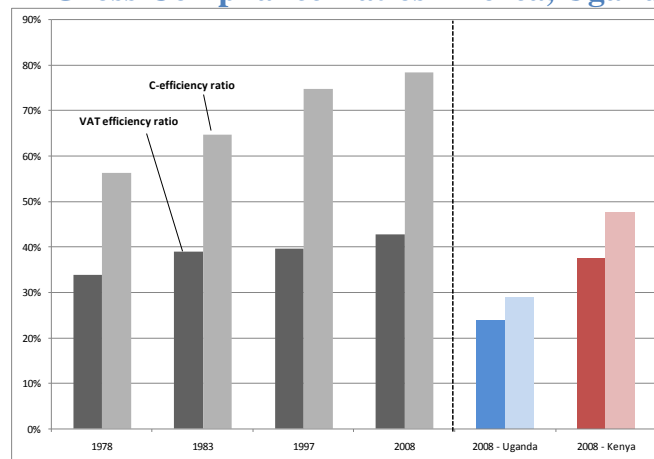
The second macro-level indicator which shows that Korea succeeded in broadening its tax base is its high level of VAT gross compliance ratio<sup>39</sup>. Because

<sup>38</sup> Data on the number of tax payers for all components of the personal income tax is not available. A detailed analysis of changes in the number of tax payers by category of personal income tax revealed that there were significant multiple counts of the same tax payers for several categories of personal income tax. For instance, one labor income tax payer was counted for each tax bracket. Therefore, for many personal income tax categories, it was difficult to determine with certainty whether an increase in the number of tax payers resulted from an increase in the number of tax brackets or an actual increase in the number of tax payers. The figure for individual business income tax was presented however because the problem did not apply to this tax category. Indeed, the number of tax brackets increased from 5 to 6 over 1966-1969, which could explain an artificial increase in the number of tax payers of 7% per year (20% averaged over three years), far below the 32% achieved.

<sup>39</sup> Ratio of VAT revenue to consumption – as a proxy for the taxable base of VAT- , divided by the standard tax rate.

of its flat rate across almost all goods and services, VAT efficiency is one of the easiest and most accurate efficiency measurements. Because VAT was put in place in 1977 at the end of the reform period examined in this study and its implementation relied on the systems that were developed from 1966 to 1976, measuring the efficiency of VAT at its inception is an indirect way to assess the performance of the reforms that prepared its implementation. Figure 5 shows Korea's Gross Compliance Ratio (GCR) for selected years in Korea, Uganda and Kenya. Firstly, Korea has had a high GCR, increasing from about 55% in 1978 to almost 80% today. This is high by international standards. Aizenman and Jinjark (2005) show that for a panel of 44 countries (including low, middle and high income)<sup>40</sup>, sampled during the period 1970-1999, the GCR of VAT ranges from "2.4% in Belarus... to 45.2% in Finland". Secondly, the Korean GCR is consistently higher than those for Uganda and Kenya, even when comparing Korea in 1978 with the two East African countries in 2008. The initial version included both C-efficiency and efficiency ratio.

**Figure 5: VAT Gross Compliance Ratios– Korea, Uganda and Kenya**



Korea's high efficiency in collecting indirect taxes contributed largely to the overall efficiency of the tax system. Indeed, indirect taxes, at 45 to 50% of revenues in the 60s and 70s, were by far the largest tax revenue contributors.

#### **4.2.2 Empowerment**

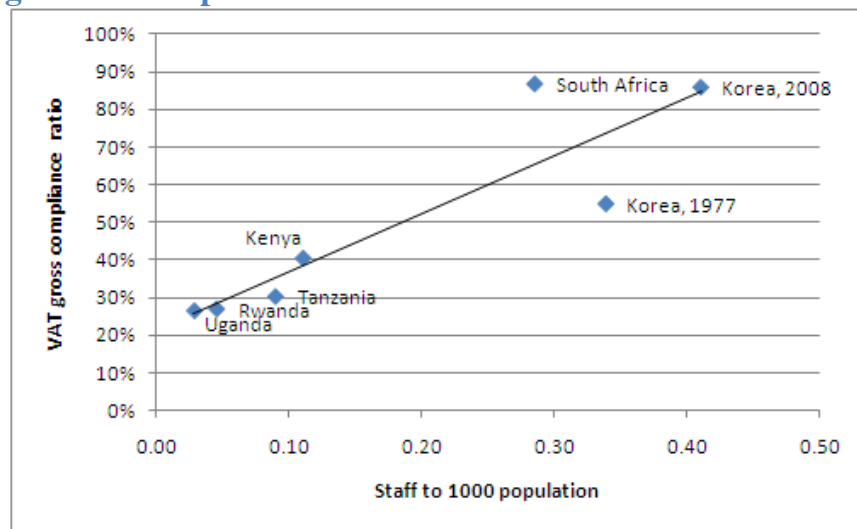
Though a combination of factors probably explains Korea's ability to broaden its tax base, we present one distinctive feature which played an important role: the

<sup>40</sup> See Aizenman and Jinjark (2005) for a list of the countries.

empowerment of the tax administration. Two aspects of the high level of empowerment of NTS are the President's personal support to the Commissioner against external pressure, and the relatively large size of Korea's tax administration.

The tax administration was protected by top government officials from interference in its operations. For instance, as explained in chapter 3.3.2, the President personally supported the Commissioner against external pressure. In contrast, many examples can be found in Sub-Saharan Africa (SSA) of Commissioners or high ranking officials being changed as a result of external influence. For instance, following the creation of the Kenya Revenue Authority, the first two Commissioner Generals did not complete their three year terms. In Uganda in 1998, as a result of distrust between Uganda Revenue Authority (URA) and the political leadership, MoFPED curtailed the mandate and administrative autonomy of URA's Board with an explicit cue from the President<sup>41</sup>.

**Figure 6: VAT performance and size of the tax administration**



Source: fiscalreforms.net, WDI, RRA, calculations by the authors

Notes: Figures are for 2008, unless specified otherwise

Because Korea's revenue authority does not collect customs taxes, in other countries adjusted staff number were calculated by multiplying the total staff number by the share of non customs taxes in tax revenues.

This provides an estimation of staff number for a similar organization focusing on domestic taxes only.

In addition, Korea's tax administration in 1977 had a higher number of staff members than EAC administrations by several orders of magnitude. Korea had about 5 times as much staff per population as the EAC on average today<sup>42</sup>, and up to 10 times more than Uganda.

<sup>41</sup> Fjeldstad (2005)

<sup>42</sup> Excluding Burundi, for which data was not available.

Analyzing the breadth of the tax base against the size of the administration suggests that EAC tax administrations may be inadequately resourced. Figure 6 plots VAT GCR against the size of the tax administration (as explained in the previous chapter, for lack of better measures available, VAT GCR is used as a proxy for measuring the breadth of the tax base). In this sample no tax administration has achieved the VAT performance of Korea and South Africa with significantly less staff. This does not mean that increasing the size of the administration is *sufficient* to achieve a broader tax base, but does indicate that more adequate resources may be *necessary* to do so<sup>43</sup>.

**Table 3: Size of revenue authorities and performance (2008 values unless specified otherwise)**

	Korea, 1966	Korea, 1969	Korea, 1977	Korea, 2008	Kenya	Uganda	Tanzania	Rwanda	South Africa
Staff to 1000 population (excl. customs) (1)	0.19	0.30	0.34	0.41	0.11	0.03	0.05	0.09	0.29
Operating cost to revenue (2)	2.1%	1.8%	1.5%	1.1%	1.6%	3.0%	2.8%	2.7%	1.0%
Domestic tax revenues	7%	10%	10%	15%	19%	12%	15%	14%	28%
VAT gross compliance ratio	N/A	N/A	55%	86%	41%	27%	27%	30%	87%

Source: Fiscal reform.net, TRA, KRA, URA, SRA reports and IMF staff reports, NTS, WDI, calculations by the authors

Notes: (1) Because Korea's revenue authority does not collect customs taxes, in other countries adjusted staff numbers were calculated by multiplying the total staff number by the share of non customs taxes in tax revenues. This provides an estimation of staff number for a similar organization focusing on domestic taxes only.

(2) Only domestic costs and revenues in Korea, total costs and revenues in other countries, including customs

Using the operating-cost-to-revenue ratio as benchmark for the size of a tax administration is misleading and can result in undersized administrations. This ratio is often quoted to justify limiting the size of EAC tax administrations. For instance, an operating cost ratio of 3% in Uganda (see Table 3: Size of revenue authorities and performance (2008 values unless specified otherwise)) would be considered high though to indicate that Uganda's tax administration is too large. This is incorrect as it measures size only against one dimension of performance: revenue-to-GDP. It leaves out another critical dimension of performance: the breadth of the tax base, also rightly called efficiency of a tax. In the case of Korea, generating high levels of revenues was not an objective, in line with Korea's small government budget strategy. Revenue targets and tax rates were intentionally low,

<sup>43</sup> One should exert caution when directly comparing sizes of tax administrations across countries and time periods. For instance, a country with a larger population or economy should normally be able to achieve better economies of scale. In addition, information technologies which were not available in the 60s are now widely used and contributing to increased efficiency. In practice, adjusting for differences in these factors is difficult. However, in this specific case, the assumption of the authors is that the effect of adjustments would be marginal compared to the very large size difference between administrations in the EAC on the one hand, and South Africa and Korea on the other hand.

automatically resulting in a relatively low average operating-cost-to-revenue efficiency ratio, at 1.8% in 1969. However, this low ratio, reflecting high level of operational resources, could be justified by a good performance on broadening the tax base. It is therefore incorrect to conclude from a high operating-cost-to-revenue ratio that resources are inefficiently used and that resources should be reduced.

#### **4.2.3 Accountability and empowerment, two sides of the coin**

As explained in chapter 3.3.1, accountability took three main forms: close performance monitoring at the highest level, target revenue approach and incentives for performance, and a zero-tolerance for corruption. Most countries implement these forms of accountability mechanism to some extent. However, the fact that President Park personally monitored the performance of NTS sets Korea apart and illustrates the commitment for results at the highest level.

Empowerment and accountability should be viewed as two sides of the same coin. Providing large resources and protection from interference at the operational level could have resulted in efficiencies without a tight supervision. Reciprocally, the high pressure to deliver would have been fruitless without adequate means.

## 5 Conclusion

**Tax reforms significantly contributed to Korea's successful development.** They helped Korea rapidly achieve fiscal balance and promoted savings and investment through incentives. However, one of the key reasons for the success of Korea's tax reforms was their full integration into the broader national strategy. Indeed, fiscal balance was only achieved because expenditure was reduced, and tax incentives for investment only had an impact because they complemented credit-based incentives.

**This study found two lessons of particular relevance to EAC member countries.** First, Korea achieved faster results by focusing its tax policies on a few priorities fully aligned with its national development strategy. Second, Korea broadened its tax base by both making the tax administration both empowered and accountable.

**One useful way to read these lessons is that part of Korea's success can be explained by a strong emphasis on implementation, beyond strategy and policies.** In fact many of Korea's policies and strategies have been adopted in the EAC in one form or another. These include for example incentives to promote investment, simplified tax filings for small enterprises, special initiatives for large payers... Korea therefore stands out for its emphasis on implementation rather than the nature of its policies. Indeed, focused and coherent strategies are a prerequisite for solid implementation. Empowered and accountable execution agencies are critical for effective delivery. Implementation plays a central role in Korea's experience in general, beyond the field of taxation. As an illustration, it is said that President Park allocated 20% of his time to decision-making, and 80% to implementation. As a result, over his 18 years of tenure, he spent 119 days a year across all parts of Korea, demonstrating his commitment for results, monitoring them and listening to practical feedback from the ground.



## Annex I - Chronology: politics, economy and taxation

Year	SYP	Politics	Economics	Taxation
1948		Republic of Korea proclaimed (split into North and South Korea)		<b>Creation of modern tax system</b> Major tax acts: income, corporation, liquor (and later inheritance and commodity)
1950		Invasion by North Korea		<b>War tax acts</b> Land and temporary tax revenue expansion acts Land income tax replaces general income tax
1953		<b>End of Korean war</b>		<b>Reestablishment of civil tax regime</b> based on Wald's report abolishment of war taxes textile tax absorbed in commodity tax license tax transferred to local governments progressive income tax introduced corporate tax based on estimated results introduced
1958				Three new taxes to increase revenues Education tax (surtax on personal income) Asset revaluation tax Foreign exchange tax (targeting black market)
1960				Tax reform of the Democratic Party <b>Direct taxes reduced, indirect taxes raised</b> Introduction of tax exemptions for export and investment
1961		<b>Glorious revolution - Park Chung Hee president</b>	<b>Economic Planning Board established</b> <b>First devaluation</b>	<b>Special measures to curb tax evasion</b> Temporary emasure for tax collection Special measure for tax evasion punishment Revision of income, coroporation and business tax New accounting system <b>General tax administration reform</b> Tax administration simplified Regional tax offices reorganized Tax officials screened
1962			<b>First 5Y EDP: export manufacturing</b>	<b>First comprehensive tax reform</b> <b>Focus: administrative efficiency, growth</b> Tax given a central role for growth promotion Reduction of number of taxes (38 to 28, 15 national taxes) 10 tax laws revised Adjustment law for national and local tax National tax appellate application law
1963				Foreign exchange tax abolished
1964			<b>Second devaluation</b>	
1965		Normalisation of relationships with Japan	Beginning of international borrowing (including from Japan)	
1966				<b>Office of National Tax Administration created</b> target revenue approach adopted

1967			<b>Second comprehensive tax reform</b> <b>Focus: growth, equity, administrative efficiency</b> Substantial expansion of tax exemptions for manufacturing export Reduction of taxes on capital gains from listed companies, and interests on bank deposits to promote savings Liquor and commodity tax raised to discourage consumption of target goods Investment credit and special depreciation on strategic industries to support investment 19 tax laws revised Real estate speculation control tax introduced Partial global income tax introduced Higher bracket income and inheritance tax rates raised, lower brackets lowered for equity
1968			Measure to improve compliance tax penalties raised, tax credits for voluntary returns increased, acceleration of return of overpaid taxes, improvement of the tax appeal system
1969			Revision of laws to improve voluntary submission (6 laws including corporate)
1970			
1971		New Community policy (high grain prices). Before that, low grain prices were imposed.	<b>Third comprehensive tax reform</b> expansion of corporate and investment tax incentives. Special tax exemptions and depreciation up to 80% for strategic industries, including small and medium size businesses
1972		<b>Third 5Y EDP: diversification</b> heavy and chemical industries, steel, machinery, shipbuilding, electronics, oil refining	Emergency decree for economic stability and growth generous investment tax credits abolished revenue sharing scheme for local governments
1973		<b>First oil crisis</b> Followed by a sustained inflation in the 70's	
1974			<b>January - Emergency tax reforms</b> <b>Focus: equity (protect poor from inflation)</b> Tax relief for low wage earners <b>December - Fourth Comprehensive tax reform</b> <b>Focus: equity and growth</b> Comprehensive global income tax introduced Capital gains tax replaces real estate speculation control tax Tax exemptions for strategic industries (shipbuilding, machinery): choice given between one of three: direct exemption, investment credit, special depreciation Business tax rates raised to prepare for VAT Withholding tax extended to manufacturers and wholesalers Reporting system reinforced Basic law for National Taxes: improve taxpayers rights by prohibiting retroactive taxation, introducing assessment based on bookkeeping and establishment of the Tax tribunal as a special independent agency
1975			defense tax law introduced
1976			<b>Fifth comprehensive tax reform</b> VAT and special excise tax introduced 8 of 11 indirect tax laws revised entertainment and food tax become national registration tax becomes local
1977			
1978			
1979		Recession following stabilisation measures to fight inflation	
1979	Park Chung Hee assassinated, followed by continued military rule	<b>Second oil crisis</b> <b>Major shift towards liberalization</b>	
1980			Reforms to reduce exemptions
1987	<b>First democratic elections</b>		
1989			Global landholding tax introduced, to curb land speculation
1990			Defense tax law abolished
1996			Global income tax includes financial revenues Self-assessment introduced Corporate tax reduced to improve competitiveness
1997		<b>East-Asian financial crisis</b>	Tax reforms to facilitate restructuring and attract FDI

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